

Summary of Current System

	Pillar 1	Pillar 2	Pillar 3
Type:	♦ Defined-contribution	♦ Defined-contribution	♦ Defined-contribution
Participation:	♦ Mandatory	♦ Mandatory	♦ Voluntary
Management:	♦ Publicly-managed	♦ Privately-managed	♦ Privately-managed
Financing:	♦ PAYGO	♦ Fully-funded	♦ Fully-funded
Coverage:	♦ Working population	♦ New labor market entrants after July 1, 1998 and current employees who elect this option	♦ Individual employees
Eligibility:	♦ Gradual phase-in of retirement age to 62 years for both men and women	♦ Gradual phase-in of retirement age to 62 years for both men and women	♦ Gradual phase-in of retirement age to 62 years for both men and women

Problems Leading to Pension Reform

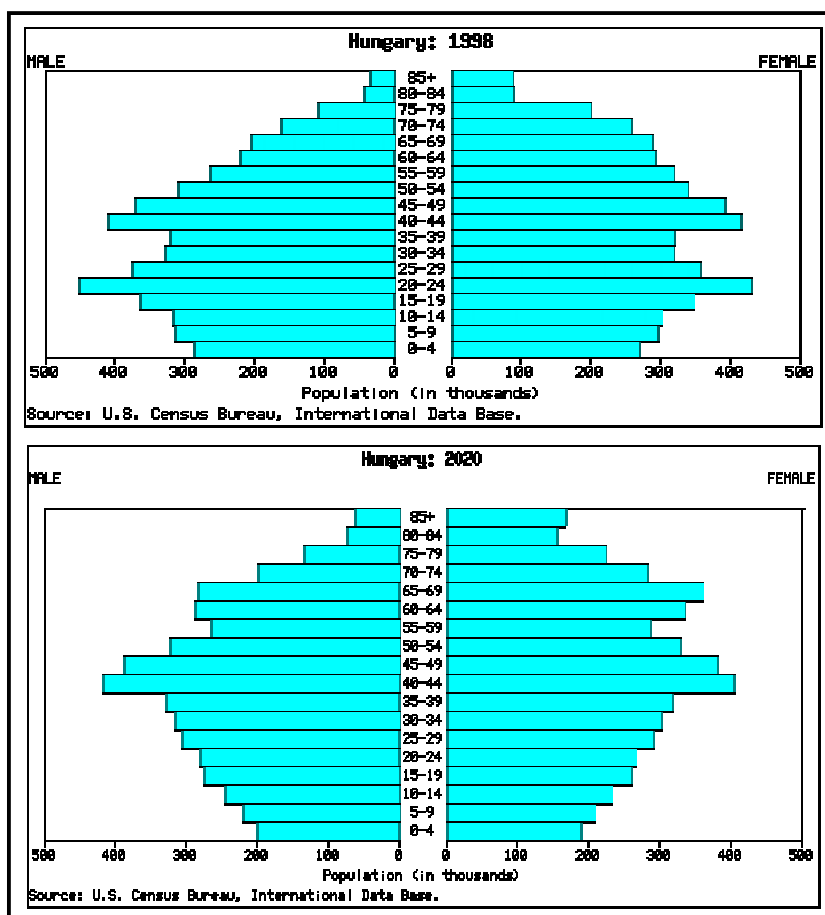
- ❑ Demographic shifts
- ❑ Economic transition and fluctuations
- ❑ Generous benefits

Summary of Current Pension System

Hungary has introduced a multi-pillar system to replace their previous defined-benefit scheme, financed on pay-as-you-go (PAYGO) basis. Pension reform was approved by parliament in July 1997 and initiated in January 1998. This multi-pillar system includes a “modernized” or reformed version of the PAYGO system, a mandatory fully-funded second pillar which partially funds the PAYGO system, and a privately-managed third pillar based on voluntary contributions to pension funds. In addition to this multi-pillar scheme, the pension system includes a “zero pillar” which provides assistance to low-income pensioners. This pillar is financed through the central budget.

As of July 1998, all new entrants to be labor force are automatically placed in the multi-pillar system. Current workers and those entering the labor force prior to July 1998 may select the new system or remain in the reformed PAYGO system. However, all employees are expected to have made their selection by September 2000.

The pension system provides old-age benefits, disability pension, and survivors pension. Both employers and employees continue to contribute to the first pillar or PAYGO system. Employer contributions amount to 24 percent of payroll in 1998 (23 percent in 1999 and 22 percent, thereafter).



Employees who have chosen to remain exclusively in the PAYGO system contribute 7 percent of wages in 1998 (8 percent in 1999 and 9 percent, thereafter). Those employees in the mandatory second pillar contribute 1 percent of their wage to the reformed PAYGO system. The central government is responsible for any deficits incurred by the PAYGO system.

SELECTED INDICATORS		
Demographic	Year	
	1998	2020
Total Population (in thousands)	10,232	9,604
Life Expectancy at Birth (Years)	70.83	77.10
Total Fertility Rate (Child Born per Woman)	1.45	1.32
Age Dependency Ratio (percent)	30.8	44.7
	1980-2000	2000-2020
Average Annual Rate of Population Growth (percent)	-0.3	-0.3

Source: U.S. Bureau of the Census, International Data Base.

Economic	1996
GNP (PPP in billions) ¹	68.6
GNP Average Annual Growth Rate, 1995-1996 (percent) ¹	2.2
GNP Per Capita (in PPP) ¹	6,730
Inflation Rate (percent) ²	23.5
Labor Force Participation Rate (percent) ³	47.4
Unemployment Rate (percent) ³	11.0

Source: ¹World Bank; ²IMF; ³International Labour Office.

Pension	1997
System Dependency Ratio, 1996 (percent)	76.9
Employee Contribution for Pensions (percent of earnings)	7.0
Employer Contributions for Pensions (percent of payroll)	24.0
Public Pension Spending as % of Government Spending	n/a
Public Pension Spending as % of GDP, 1996 (percent)	9.7

Source: International Monetary Fund; State Private Funds Supervision.

The amount of the old-age pension from the PAYGO system is based on the number of years of service and average monthly earnings. The current retirement age is 57 years for women and 61 years for men; however, the retirement age will increase to 62 years for both men and women by 2009. This benefit formula was modified to provide a stronger link between contributions and benefits.

The mandatory private pension system (second pillar) established a link between the first and second pillars of the pension system. Employer contributions to the second pillar are the same as those provided in the reformed PAYGO system. Those employees who affiliate with the mandatory second pillar contribute 6 percent in 1998 (7 percent in 1999 and 8 percent, thereafter). Thus, participants in the second pillar, at retirement, will receive benefits from both the PAYGO system and their contributions to the second pillar.

The third pillar, or voluntary private pension fund system, has been in existence since 1993. The reform efforts however have included tax incentives to encourage growth of this pillar. This pillar allows individuals to increase their savings for retirement. About 249 private pension funds were available in 1997, with over 450,000 participants. Private pension fund managers were responsible for over US\$145 million assets.

Problems Leading to Pension Reform

Many factors initiated the reform of the Hungarian pension system. Those receiving social security benefits increased, and by 1996 the system dependency ratio (of pensioners to contributors) had reached 59 percent. This was primarily due

to an increase in individuals receiving early retirement and disability benefits and adverse economic conditions. Between 1985 and 1995 disability claims nearly doubled (increasing from 85 to 160 per 10,000 covered workers). Economic conditions resulting from Hungary's transition from a centrally planned economy to a market economy also affected the pension system. The country experienced a decline in labor force participation (from 85 percent in 1990 to 76 percent in 1994) and an increase in unemployment (from nearly zero in 1990 to 10 percent in 1994). Pension fund deficits in 1996 amounted to 1.2 percent of GDP.

Challenges Facing Pension System

The implementation of pension reform poses additional challenges. First, the government must manage the costs associated with transitioning to a multi-pillar pension system. The revenue loss from diverting PAYGO contributions to the second pillar is estimated to amount to at least 0.8 percent of GDP. The government intends to pursue a debt financing agenda during the transition years and then gradually switch to a tax-financing strategy in the next decade.

Additional reform efforts include an updated indexation mechanism that will be implemented after the transition phase which is expected to be completed in 2012. Pension benefits are currently indexed to changes that occurred in the average wage during the previous year. This will gradually be replaced by the Swiss indexation mechanism which combines both price and wage indexation. The Swiss mechanism index uses 50 percent wages and 50 percent consumer price index.

Administrative improvements to the pension system will also be necessary, especially in taxpayer identification, contribution collection, pension record-keeping, and current account management.

Pension Reform Efforts by Pillar

	Pillar 1	Pillar 2	Pillar 3
Papers issued on state of pension systems	✓	✓	✓
Formulation of proposals	✓	✓	✓
Development of draft legislation	✓	✓	✓
Introduction of legislation by parliament	✓	✓	✓
Review of legislation by parliament	✓	✓	✓
Passage of legislation by parliament	✓	✓	✓
Implementation of legislation	✓	✓	✓